

Elegibility Criteria for FTR Market Participation

Prepared For Consideration by
FTR Credit Working Group
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Market Participant Eligibility Overview: Key Questions

- **Motivation: Without participant eligibility requirements, there are no means to ensure credit worthiness of participants beyond their ability to meet current financial assurance requirements**
- **Core questions needing to be addressed if ISO is given the ability to set eligibility criteria:**
 - Quantitative Criteria: Should there be a minimum capitalization level for market participants?
 - Capitalization requirements would ensure an asset base sits behind a participant's portfolio
 - Need for differentiation between hedging behavior and speculative behavior
 - Some precedent in CFTC regulated markets and other exchanges
 - Qualitative Criteria: What qualitative criteria, if any, should be used in addition to capitalization levels?
 - Establish experience in trading, risk control, and ability to meet changing collateral levels
 - Requirements likely need to be made prescriptive enough (non-discretionary) such that FERC will approve
 - Enforcement: How should market entry process be structured to allow for concerns around participant eligibility to be addressed?
 - Should ISO be given ability to delay market entry pending resolution of questions?
 - Provide Budget & Finance or other committee's final approval rights for participation?
 - What rights should be provided the ISO in surveillance of existing FTR participants?
- **Other markets/exchanges employ eligibility requirements to reduce pool exposure**
 - General approach is part of U.S. Code regarding futures trading

Quantitative Criteria: Minimum Capitalization Levels

- **Goal: Outline required capitalization levels for participation**
- **Issue Overview:**
 - Commodity Exchange Act suggests a starting point by specifying requirements for both hedgers and speculators
 - hedger net worth at \$1,000,000
 - speculator net worth at \$10,000,000
 - How to define hedgers vs. speculators?
- **Capitalization levels appear appropriate for FTR markets**
 - Hedging level should not present a problem for smaller physical players in the ISO markets
 - Speculation levels may reduce “trader’s option” behavior in FTR market (retaining profits vs. socializing losses)
 - Should prevent thinly capitalized players from taking outsized risks
 - However, capitalization alone may not be sufficient if not at risk
 - At lower levels, the risk increases that a participant would abandon a losing portfolio
 - May be an opportunity to permit capitalization levels below threshold in exchange for position limits or margin premiums
- **Definition of hedger vs. speculator needs to be established**
 - Could allow self-designation - though that would be open to gaming
 - Though difficult to set exact definition, may be necessary to explicitly outline
 - One route would be to set a threshold for % of portfolio that must correspond to ISO energy transactions
 - Starting point might be to set a “hedger” threshold where 80% of a hedging portfolio would be directly tied to positions in the energy markets
 - Should require that hedged transactions be internal to ISO markets, otherwise assets and liabilities are separate
 - Many portfolios include both speculative and hedging positions

Qualitative Criteria

- **Goal: Outline required qualitative tests for participation**
- **Issue Overview:**
 - Commodity Exchange Act provides a starting point by defining eligible contract participants as entities with demonstrated extensive experience in trading and risk management associated with commodity and derivative trading
 - Other markets requiring entities be Eligible Commercial Entities only require that prospective participants represent that they meet the requirement
 - NYMEX, LCH Clearnet, among other clearinghouses utilize compliance committees to assess targeted members' market, trade, and financial risk
- **Qualitative tests should allow ISO to be satisfied that participants are able to address issues around trading experience and risk management as they pertain to the FTR markets**
 - To meet FERC requirements, need to make tests prescriptive (minimally subjective) in nature
 - Experience in trading and risk management difficult to define
 - Potentially require a track record in other investment products
 - Potentially require participants to define perceived "risks" in FTRs to ISO
 - Should require participant to demonstrate ability to track / manage collateral requirements and detail procedures for managing cash flow exposures
 - Should require participants to complete FTR market training as pre-requisite to market participation

Enforcement Rights

- **Goal: Define enforcement rights and processes**
- **Issue Overview:**
 - Need to establish ISO / Participant rights in new participant approval process as well as existing participation
- **Evaluation of new applicants for FTR market participation**
 - The ISO should be given rights to delay participation, but ultimately, decision should go to ISO stakeholders
 - If results of qualitative/financial tests are unambiguous, approval for FTR market rights likely doesn't need to go before full membership body
 - If any ambiguity, ISO should make a recommendation to a relevant body of stakeholders
 - Ultimately, all stakeholders bear default risk for participants - if ability of participant to meet criteria is ambiguous, then participants should be in a position to decide whether to allow market entry
 - Possible use of independent party if concern over dissemination of sensitive participant information and/or conflict of interest
- **Surveillance of existing FTR participants**
 - Failure to maintain standards or evidence of “high risk” behavior (e.g., frequent margin calls)
 - Non compliance results in margin haircut

Recommendations

- Quantitative
 - Institute minimum capitalization requirements for FTR market participation
 - Alternate capitalization levels for Hedger v. Speculator
 - hedger net worth at \$1,000,000
 - speculator net worth at \$10,000,000
 - permit self-designation
 - Participants required to provide necessary support documentation to ISO
 - ISO may dispute designation for B&F and/or NPC determination
 - Failure to meet minimum capitalization requirements does not prevent market access
 - Results in 10% FTR FA requirement premium
 - Results in position limit of xxx MW-mo

Recommendations – Cont'd

- Qualitative
 - Must establish experience in trading and risk management
 - Required to demonstrate:
 - a track record in other investment products
 - ability to track / manage collateral requirements and detail procedures for managing cash flow exposures
 - to define perceived “risks” in FTRs to ISO
 - Require participants to complete FTR market training as pre-requisite to market participation
- Surveillance
 - Company, its officers and traders must not be subject to any serious regulatory or legal sanctions (CFTC, SEC, FINRA, etc)
 - Examples include censure, suspensions, bans
 - Evidence of high risk behavior (cross-default in other energy markets; excessive ISO-NE margin calls and/or late payments) results in margin haircut of 10%